A 3840-64

ECONOMIC
OUTLOOK

Chamber of Commerce of the United States July/August 1985

TAX REFORM

by
Richard W. Rahn

The following are excerpts from testimony presented before the House Committee on Ways and Means on June 26, 1985.

Americans from all walks of life support tax reform because they believe that it will enhance their material well-being by eliminating onerous provisions and creating opportunity for economic advancement. Absent these objectives, however, tax reform would be an unproductive exercise, the cost of which, both in political and economic terms, would vastly outweigh the benefits.

In the context of reforming a body of law as complex as our tax code, economic opportunity is a rather amorphous objective and, as such, requires the formulation of more specific standards. Such a standard can be operationally defined by reducing the goal of economic growth into its component parts and using these as the basis for measuring the desirability of any reform proposal. For the purposes of our evaluation, we have selected the following contributors to growth as the key standards by which to evaluate any tax reform proposal: (1) capital formation; (2) technological advancement; (3) international competitiveness; and (4) job creation. It is our belief that any tax reform proposal which does not enhance the prospects of each of these objectives is a costly exercise with limited benefits to the American people.

In our view, the Administration's tax reform proposal improves our present system but does not take that extra step which would make the package a truly growth-inducing set of reforms. Indeed, most of the analyses performed to predict the impact of the tax plan, including the Treasury's own projections, indicate that the package, as presently constituted, only moderately advances economic growth beyond what is expected under current law.

The goal of tax reform should be to reach a growth path for real gross national product that is at least one percentage point higher than what would otherwise occur. With the unemployment rate slightly in excess of seven percent, with inflation under control, and with industry operating at about eighty percent of capacity, we believe that this goal is feasible. A well-constructed package of tax reforms, combined with spending restraint and stable monetary policy, could easily achieve it.

The tax law affects each of the determinants of economic growth mentioned above. Capital cost recovery allowances affect the cost of capital and, therefore, the level of investment in plant and equipment. Capital gains tax rates also affect the cost of capital as well as the after-tax reward to risky activities, such as research or the launching of new products or enterprises. Consequently, the tax treatment of capital gains has strong effects on the level of investment and the degree of technological innovation. Marginal tax rates influence the cost of capital, the after-tax return to additional work, and virtually every other economic activity. Lower marginal tax rates will raise the incentive to invest and to work. The tax treatment of international business, in particular, of income earned abroad, has an important impact on the competitiveness of U.S. business. Finally, the tax treatment of savings has important effects on the level of saving and the capital available to sustain high rates of economic growth.

CAPITAL FORMATION

Capital Cost Recovery

For many years, capital investment had been singled out for unfavorable tax treatment. While most business

IN THIS ISSUE

Tax Reform ..... p. 1
Monetary Policy Key to Sustained Economic Growth ..... p. 7
Forecast Table ..... p. 9
Tax Incentives and the Rate of Investment ..... p. 10
U.S. Manufacturing is Alive and Well ..... p. 12
Trends in Commerce ..... p. 16

Permission granted to quote from this report with appropriate attribution to Forecast Section, Chamber of Commerce of the United States, 1615 H Street, N.W., Washington, D.C. 20062. $7.50 per copy; $60 per year.

expenses were deductible in the first year, capital expenses had to be deducted over a number of years without adjustment for inflation and the opportunity cost of money. Since the tax code ignored this "time value of money," it was biased against long-term investment.

Requiring capital costs to be recovered over a long period of time, without adjustment for the time value of money, increases the after-tax cost of the machine or structure being purchased. Adverse tax treatment forces investors to require a higher before-tax return from depreciable property in order to receive the same after-tax return. Consequently, capital investment is less attractive, investment declines and productivity and economic growth are reduced.

The Accelerated Cost Recovery System (ACRS), a cornerstone of the Economic Recovery Tax Act of 1981 (ERTA), was a first step towards increasing investment incentives. Replacement of the inadequate Asset Depreciation Range (ADR) system with ACRS reduced the cost of capital and spurred an unprecedented surge in investment in plant and equipment which made a major contribution to the strength and duration of the recovery we are now experiencing. ACRS, combined with the investment credit, is approximately equivalent to expensing in present value terms, i.e. when one takes into account the time value of money and inflation. The combination of ACRS and the investment tax credit successfully reduced the tax bias against investment.

The Administration's plan is but one of many tax reform proposals which have been introduced. Unfortunately, several of these proposals constitute a step backwards from the progress achieved through ACRS. They would reduce capital cost recovery allowances for equipment and would harm certain types of investment. Table 1 shows the effect of the various proposed capital cost recovery plans on the after-tax cost of capital. The table reflects the effect of corporate tax rate reductions, dividend deductibility, the investment tax credit and depreciation allowances. From it we see that the Administration's proposed capital cost recovery system (CCRS) would substantially raise the cost of capital for equipment. Increased capital costs will reduce investment and harm economic growth. (For a detailed discussion of this issue, see *Capital Cost Recovery and Tax Reform*, ECONOMIC OUTLOOK, April 1985).

Windfall Tax on Excess Depreciation

The Chamber is concerned about the economic effects of the Administration's proposal to recapture "excess" depreciation with a windfall tax. The Administration argues that taxpayers who have benefited from accelerated depreciation deductions would experience a windfall gain as a result of the proposed reduction in the corporate tax rate from 46 percent to 33 percent. This proposal would tax income earned from investments made between 1980 and 1985 at a 46 percent rate, and only income earned from investments made after 1985 would enjoy the lower, 33 percent, tax rate.

TABLE 1
COST OF CAPITAL UNDER VARIOUS RECOVERY METHODS

Capital Cost Recovery System	Inflation = 5% Real Discount Rate = 4%	Inflation = 8% Real Discount Rate = 5%	Change in Cost of Capital Compared to Current Law
ACRS-ITC 3 YEAR[a]	1.00	1.03	–
ACRS-ITC 5 YEAR[a]	0.99	1.04	–
ACRS 18 YEAR[a]	1.36	1.44	–
NCRS 4 YEAR[b]	1.01	1.02	+ 1
NCRS 6 YEAR[b]	1.01	1.04	+ 2
NCRS 25 YEAR[b]	1.05	1.15	– 23
SCRS 6 YEAR[c]	1.05	1.07	+ 5
SCRS 18 YEAR[c]	1.15	1.18	+ 16
SCRS 40 YEAR[c]	1.24	1.27	– 9
RCRS 5 YEAR[d]	1.02	1.03	+ 2
RCRS 17 YEAR[d]	1.08	1.09	+ 9
RCRS 63 YEAR[d]	1.20	1.22	– 12
CCRS 4 YEAR[e]	1.01	1.02	+ 1
CCRS 7 YEAR[e]	1.05	1.06	+ 6
CCRS 28 YEAR[e]	1.20	1.23	– 12
Expensing	1.00	1.00	–

[a]Present law.
[b]NCRS is the Neutral Cost Recovery System embodied in the Kemp-Kasten proposal which provides the present value equivalent of expensing.
[c]SCRS is the Simplified Cost Recovery System embodied in the Bradley-Gephardt proposal. SCRS employs lives similar to the old ADR class lives but allows a 250% declining balance method.
[d]RCRS, the Real Cost Recovery System, was originally proposed by the Treasury Department in November 1984.
[e]CCRS, the Capital Cost Recovery System, is embodied in the President's latest tax reform proposal.

The concept of windfall gains and losses would have some validity if the only tax code change proposed were the reduction in the corporate tax rate from 46 percent to 33 percent. The President's proposal, however, contains a number of other changes which are likely to offset gains from the rate reduction. Furthermore, no consideration is made under the proposal for losses due to the repeal of capital gains treatment for depreciable property and section 1231 property. It is not fair to apply the windfall gains tax only to capital investment without some compensation for the windfall losses brought about by other provisions in the reform proposal.

Dr. Richard W. Rahn, Vice President and Chief Economist.
Dr. Ronald D. Utt, Deputy Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.
Mr. Martin Lefkowitz, Director, Economic Trends and Statistics.
Dr. William Orzechowski, Director of Federal Budget Policy.
Ms. Rajni Bonnie Ohri, Economist.

The Chamber believes the windfall tax on excess depreciation will have detrimental effects on the economy. Cash flow problems will result from windfall tax payments by those companies with older investments, leaving less capital available for new investment. Reduced new investment will cause a business slowdown, especially during the three year period when the windfall tax provision is in effect. Considering that the cost of capital will be increased as the result of other changes in the proposal, the addition of the windfall tax is an excessively unfair burden on capital investment.

The Double Taxation of Corporate Dividends

The Chamber commends the Administration's proposal to provide a 10 percent deduction for dividends paid by corporations. Corporate dividends are taxed twice because corporations pay taxes on their profits, and then shareholders must pay taxes again on their dividends. This double taxation of income reduces the amount of capital available for investment and is both unfair, and destructive to economic growth. Double taxation of income encourages firms to retain earnings rather than pay profits out as dividends. It thus reduces the liquidity and efficiency of capital markets; further, it encourages concentration of business and discourages the development of new enterprises.

Capital Gains

Evidence from the 1978 and 1981 reductions in the capital gains tax rate show that both investment and federal revenues rose substantially. In 1978, the capital gains tax rate was reduced from 49 percent to 28 percent. In 1981, it was further reduced to 20 percent. These reductions in the tax rate contributed to a $2.5 billion increase in federal revenues and raised the proportion of total taxes borne by the wealthy. If we assume, as is almost certainly the case, that those with adjusted gross incomes over $500,000 are in the maximum tax bracket, then capital gains taxes paid by the wealthy were $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130 percent increase in tax revenues. (For a detailed discussion of this issue, see *Boosting Capital Formation and Tax Revenues: The Case of Capital Gains Tax Reduction*, ECONOMIC OUTLOOK, June 1985). In view of these results the Chamber strongly endorses further reduction in the capital gains tax rate as proposed in the Administration's tax reform plan.

Reduced Marginal Tax Rates

The marginal tax rate is the rate of tax a taxpayer will pay on the next dollar he earns. A taxpayer's average or effective tax rate, in contrast, is the sum of taxes he pays divided by his total income. The economically more relevant tax rate is the marginal tax rate. When making the economic decision whether to work an extra hour, a taxpayer is concerned with the degree to which the extra income will be taxed. He will not concern himself with how much tax he paid on his first $1,000 of income.

As marginal tax rates increase, so do the disincentive effects of taxation. A tax on work (employment income) makes work less attractive relative to leisure, causing many people to choose to work less. Similarly, taxes on savings (investment income) raise the price of savings relative to consumption and cause people to substitute towards present consumption. The price of consuming now is the amount of investment income foregone by the consumer (i.e., interest the money spent could have earned if deposited in the bank instead). A tax on investment income reduces the amount of after-tax income foregone and consequently makes present consumption relatively more attractive. Therefore, further reductions in marginal tax rates will raise incentives to work, save, and invest.

The Mellon tax cuts (1921-23), the Kennedy tax cuts (1963-65) and the Reagan tax cuts (1981-84), proved that reducing marginal tax rates buoys economic activity and raises tax revenues. Proponents of these rate reductions argued that they would encourage work, savings, and investment, and would lure the rich out of tax shelters and into taxable investments. In the long run, the tax cuts, by increasing the return to capital and labor could also lead to robust economic growth, an even greater expansion of the tax base and more economic benefits for everyone.

The results for 1982 and 1983 show emphatically that incentives do matter. The percentage of taxes paid by higher-income groups has increased, while that paid by lower-income individuals has actually fallen. Although ERTA reduced the top tax rate from 70 percent to 50 percent, individuals earning over $1 million in annual income paid 37 percent more in taxes in 1982, a recession year, than they did in 1981. Similarly, those earning between $500,000 and $1 million annually paid 25 percent more taxes in 1982 than in 1981. By 1983, those earning over $1 million paid 102 percent more in taxes, and those earning between $500,000 and $1 million paid 47 percent more.

Equally as fascinating is the fact that the relatively well-to-do paid a larger share of the total tax burden after the enactment of ERTA than before. Between 1981 and 1982 the tax burden of those earning over $1 million increased by about 40 percent, and the tax burden of those earning between $500,000 and $1 million increased by 25 percent. By 1983, each group was bearing almost twice as much of the overall tax burden as they were before ERTA. In fact, only those earning below $50,000 per year actually paid a smaller portion of the total tax burden the first year after ERTA was enacted.

Even partisans of big government should favor the Reagan, Kennedy and Mellon tax rate reductions for upper income taxpayers. Those tax cuts raised more money for

the government to spend. We have not examined, however, the enormous cost of high tax rates to the broader public. Both those paying taxes and those hoping to have enough income that they must pay taxes are forced to bear the burden of a stagnant economy, devoid of hope and opportunity. Low rates of economic growth have been thrust upon the American economy by those who would rather assuage their conscience by angry rhetoric and misguided attempts to punish the rich when America could have an economy sufficiently dynamic to improve everyone's living standard.

Tax Reform and Savings

As is to be expected, the tax treatment of savings affects the level of savings in the economy. Individual Retirement Accounts (IRAs), Keogh retirement plans, 401(k) savings plans, and the tax treatment of corporate pensions all reduce the tax bias against savings in the United States. Because these provisions reduce or eliminate the tax wedge between the before- and after-tax return to savings, savings rates are not reduced as much as otherwise would be the case under an income tax system.

The Administration's proposal would basically maintain the present treatment of retirement savings. The proposal to expand IRAs by increasing the spousal IRA amount to $2,000 would improve the savings rate. The proposed limitation on contributions to 401(k)s and defined contribution plans would tend to reduce savings. As a result, the plan's overall effect on savings is ambiguous.

The Administration has proposed disallowing employees of nonprofit organizations and state and local governments to benefit from the use of section 401(k) plans. Not only is there no economic justification for proposals to limit 401(k) plans, but also, such a proposal would discriminate against workers who are not offered retirement plans as favorable as many workers in private industry.

TECHNOLOGICAL ADVANCEMENT

The Chamber applauds the Administration's proposal for including the three-year extension of the research and development tax credit. Since it was enacted in 1981, this tax credit has stimulated research and development in the U.S. Extension of the credit will spur greater technological advancement, improve the international competitiveness of U.S. industries, and create new jobs.

Since at least the late 1960s, the United States has led the free world in terms of the proportion of total output devoted to both public and private research and development. In recent years, however, our lead has substantially narrowed. Research expenditures are a crucial element in improving our ability to compete abroad. A report released in February 1985 by the Brookings Institution and Data Resources, Inc. documents the role of industrial research in fostering economic expansion and international competitiveness. Prior to the enactment of the R & D credit, the U.S. devoted the smallest share of GNP to private industry research of any industrial nation. After the credit was enacted in 1981, the gap began to close.

A permanent research credit would offer the stable and predictable tax policy necessary to successfully compete internationally. The Brookings/DRI report provides a range of quantitative estimates of the economic benefits of a permanent credit. The most conservative estimate shows that, upon enactment of the permanent credit, GNP would rise by $1.2 billion in 1986 and $2.9 billion in 1991. "Best case" estimates show increases in overall economic activity as high as $7.5 billion in 1986 and $17.7 billion in 1991.

Investment in research is, by nature, a long-term proposition. If we are to achieve our goals of capital formation, technological advancement, international competitiveness, and job creation, research expenditures must be conducted at high levels for many years. A stable and predictable tax policy is necessary for such expenditures to continue. Consequently we recommend making the research credit a permanent feature of the tax code.

We also recommend that the Congress retain provisions in the tax code that allow research expenditures to be expensed. Research expenses, like other expenses, should be deducted in the year incurred rather than amortized over long periods. Only expensing, as under present law, eliminates the tax bias against investment in research.

INTERNATIONAL COMPETITIVENESS

The Chamber is greatly concerned with the effect of tax reform on international competitiveness. U.S. businesses presently face difficult obstacles in competing with foreign firms. These obstacles are the result of the high value of the dollar, tariff and nontariff barriers to U.S. firms entering overseas markets, and foreign government subsidization of industry. A number of provisions in the Administration's tax reform proposal would exacerbate these problems.

Proposals that increase the cost of capital will lead to higher prices on U.S. products making them less competitive with foreign-made goods. The increase in the cost of capital could also cause U.S. firms to fail to invest in more technologically advanced processes, and as a result, make U.S.-produced goods relatively less competitive. Moreover, there is strong reason to believe that inadequate capital cost recovery allowances could cause U.S. businesses to locate their manufacturing plants abroad where the tax treatment of investment is more favorable.

In addition to the capital formation provisions, several of the international tax aspects of the proposal will also affect the ability of U.S. firms to compete internationally.

Foreign Tax Credit

The Administration has proposed calculating the foreign tax credit limitation on a per country basis, rather than under the overall method currently in use. The U.S. rules for calculating the foreign tax credit are designed not only to prevent double taxation of foreign source income but also to limit the credit to U.S. tax imposed on income earned and taxed overseas. The credit is designed so that it does not reduce U.S. tax on income earned from operations in the United States. This is true whether or not an overall limitation or a per country limitation is used.

The overall limitation permits averaging of taxes paid in high-tax countries with those paid in low-tax countries. Although Treasury may regard averaging as a potential abuse, averaging of *bona fide* foreign taxes imposed on foreign source income is a proper attribute of a foreign tax credit. This is true because within the context of global business operations, averaging is a realistic way of dealing with the complexities of international trade where business is ordinarily conducted on an integrated rather than a per country basis. Averaging mitigates the mismatching that is often caused by the different rules that exist between countries for determining the tax base and the timing of income and deductions. Most countries that avoid international double taxation either use an overall limitation (as does Japan), exempt direct investment income, or use a per country limitation that permits a form of averaging and bears no resemblance to the more exacting per country method proposed by the Administration. Thus, adoption of a per country limitation, as proposed by the Administration, would cause U.S. companies to be subject to greater double taxation of foreign income relative to their foreign competitors.

Companies do not organize strictly on a country-by-country basis. A German manufacturing subsidiary of a U.S. company may well develop technology that it licenses to a Dutch or Japanese enterprise and will sell its products throughout Europe, Africa, and perhaps elsewhere, doing so through branches or sub-subsidiaries. The averaging effect of the overall method is consistent with the approach normally taken by U.S. businesses in making investments abroad, that is, to serve broad geographic markets which may involve production, transportation, and marketing facilities in several different countries.

As is stated above, the Administration's per country proposal would put U.S. businesses at a competitive disadvantage when compared to the foreign tax credit rules used by our trading partners. Our major trade rival, Japan, has an overall limitation. Additionally, Japan has a network of tax sparing treaties, which allow Japanese firms to credit the tax foregone by the host country against tax liability to Japan. When combined with the use of the overall limitation, this provides Japanese companies a credit for taxes that were never paid. The Japanese system provides Japanese business with a tax advantage over the United States even under current law, which would be greatly exacerbated if the Administration's per country proposal were adopted.

Canada, France and Germany employ a mixed system which primarily relies upon exemption (under treaty or by statute), and permitting foreign tax credits under the per country method where exemption does not apply. However, in those countries using a per country method, including the United Kingdom, a form of averaging is permitted through the use of third country holding companies.

Thus, the per country proposal would lead to an increase in the overall effective tax rate on foreign source income of U.S. businesses and decrease U.S. competitiveness. Foreign investment and operations by U.S. businesses provide significant benefit to the U.S. economy in the form of jobs, increased exports, and tax revenue. At a time when the President's Commission on Industrial Competitiveness has called for the elimination of practices that are impeding the ability of U.S. companies to keep pace with the "new reality of global competition," Treasury proposes to introduce a new barrier to the penetration of foreign markets: the per country limitation.

Sourcing Rule Changes

Our tax laws define the source, foreign or U.S., of income and expenses for the purpose of defining the scope of U.S. taxation and where primary jurisdiction for taxation of U.S. citizens is conceded to a foreign country because income is deemed to be earned in that country. The source of income and expenses of U.S. taxpayers becomes part of the formula for determining the amount of the foreign tax credit allowed to U.S. taxpayers for taxes paid to foreign jurisdictions because the credit is allowed only to the extent foreign taxes are paid on "foreign source" income.

The proposed changes with regard to the sourcing rules for sales will directly increase the tax on income earned from export sales. Last year the Administration proposed and Congress enacted the Foreign Sales Corporation provisions because they recognized the importance of encouraging U.S. exports given the size the U.S. trade deficit. Yet, the proposals to change the source of income rules as applied to export transactions substantially undercut that effort without any analysis of the impact such a change might have on U.S. trade. Indeed, the obvious effect of this proposal would be to either (1) increase the tax on U.S. exports, or (2) force exporters to establish more fixed places of business outside of the United States. We query whether our national policy should be to do either.

JOB CREATION

Since November 1982, when the economic recovery began, American business has created nearly 8 million

jobs. Of these, 66 percent were created by small businesses who are playing an increasingly significant role in our economic success. The Chamber applauds the interest the Administration has shown regarding the impact of this tax proposal on small business. We must ensure that these companies do not receive a major tax increase under any tax reform plan adopted. The retention of the graduated rates, which is part of the Administration's proposal, is an essential ingredient of any plan.

As over 80 percent of small businesses are unincorporated, the reduction in the tax rates for individuals will greatly benefit them. Reductions in corporate and individual tax rates will provide more capital for business expansion, thus leading to the creation of more jobs and to greater economic growth. It is crucial to the economic success of this country that once the base is broadened in exchange for lower rates, that these rates not be raised later.

The differential between capital gains and ordinary income tax rates is also important to maintain. The retention of a capital gains rate helps to make venture capital available to businesses for expansion. The availability of venture capital is particularly important to small businesses who have a very difficult time attracting sufficient financing.

Because payroll taxes have a direct effect on the cost of labor, we are concerned about proposals to tax workers' and unemployment compensation. Since each state sets maximum benefit levels for both workers' and unemployment compensation, taxation of these benefits (at the federal *and* state and local level, since most state taxation policy mirrors that of the federal government), will require increases in outlays to offset such taxation solely to maintain current, net benefit levels. The federal government has its own workers' and unemployment compensation programs, and benefits under these programs would also face similar outlay increases to maintain current, net benefit levels. The increased benefit levels would be funded through increased payroll taxes, in the case of unemployment compensation, and increased premiums in the case of worker's compensation. The resulting increase in the payroll tax burden will affect an employer's decision to hire additional workers, especially in the case of small businesses for whom the payroll tax cost of hiring workers plays a significant role in employment decisions. Increasing the payroll burden on employers (and, in turn, the ultimate cost to consumers of goods and services) will decrease the incentive to expand employment and exacerbate the ability of U.S. firms to compete abroad.

Employee Benefits

The U.S. Chamber supports the development and maintenance of a strong, voluntary, nondiscriminatory, private sector employee benefits system, which can vary in accordance with the needs of employers and employees. Accordingly, proposals to subject employee benefits to taxation and further regulation are of concern to us.

The Reagan Administration had been correctly committed to reducing the incidence of government intrusion in the marketplace. Its goals of privatization and deregulation of certain government services are shared and supported by the Chamber. However, new rules regarding distribution and nondiscrimination requirements for employee benefit plans would be inconsistent with these goals.

Incentives for business to offer health and insurance benefits to employees reduce the utilization of, and pressure on government-provided services. Reduced regulation and taxation of employee benefit plans would reduce business costs and allow greater flexibility in choice of benefits for workers. The Employee Benefit Research Institute estimates that the $100 billion worth of health coverage provided by employers to some 82 million workers costs the government less than one-third of that amount in foregone taxes. The replacement cost of similar health protection provided directly by the government would be the full $100 billion.

The Chamber encourages continued efforts toward privatization alternatives to government programs, such as individual retirement accounts and Keogh plans. Increased privatization will reduce reliance on the already overburdened Social Security system and provide better returns on worker investment.

Under the proposed changes, however, many currently tax-qualified retirement plans will not maintain that status, and numerous businesses – especially small businesses – will be discouraged from establishing retirement savings plans due to their increased administrative complexity. As a result, the Social Security system may be called upon to provide a greater proportion of retirement security.

In short, employer provided benefits are serving an important function more efficiently and at a lower cost than the public sector could meet the challenge. New rules on the operation of benefit plans are contrary to the objectives of fairness and simplicity in the tax code and cause extreme problems for small business.

CONCLUSION

The Chamber commends the President on his tax reform package. It is a positive step towards the much needed reform that this country awaits. In 1981 President Reagan started down this path by supporting the changes included in the Economic Recovery Tax Act (ERTA). The economic response to ERTA is unsurpassed. Investment and GNP are rising, interest rates and inflation are low and declining and productivity has improved. However, the Administration's proposal must be improved to assure that it enhances economic growth in order to continue the spurt in the economy begun by the 1981 changes.

Congress now has the tremendous opportunity to design a tax reform plan which will continue to increase economic growth. The benefits of a dynamic economy flow to all Americans. But a growing economy is most fair to the least advantaged Americans, those that most need the improved living standards that only a growing economy can provide. To increase capital formation and enhance job creation, the Congress should improve the proposal's capital cost recovery system so it is equal to, or better than, present law. International competitiveness must not be impaired by our tax code. As written, the foreign tax credit provisions of the proposal would lessen the ability of American businesses to compete abroad.

The Chamber applauds the proposal's support of technological advancement by the retention of the R&D credit. The reduction in capital gains tax rates will spur capital formation and reduce the tax bias against risk-taking. Reduced corporate and individual tax rates will increase the incentive to work, save and invest thereby increasing economic growth.

Never has this country been more ready for a sweeping change to our tax system. Support for tax reform is bi-partisan. Tax reform, properly conceived and executed, can fuel an unprecedented economic expansion. In crafting such a sweeping change in the tax system, Congress should provide for reasonable and fair transition rules so as not disrupt normal business activity.

MONETARY POLICY KEY TO SUSTAINING ECONOMIC GROWTH

by
Ronald D. Utt

Despite the recent report that second quarter GNP growth advanced at an unexpectedly strong 3.1 percent, there remain pervasive doubts about the prospects for the remainder of the year. In support of the pessimistic view is the seemingly endless stream of bad news from the many monthly and weekly reports on various segments of our economy. Industrial production has been flat since late last year and may not improve much in the near term as a result of the growing penetration from imported goods. In May, the merchandise trade deficit rose to $12.7 billion, the second highest on record. The deficit was carried to that level by the second highest monthly level of merchandise imports. With the economies of our major trading partners continuing to stagnate and with the dollar still highly valued, substantial import pressures will persist for the rest of the year.

The housing sector presents a mixed picture, although it should be doing much better considering the sharp drop this spring in mortgage interest rates. Total housing starts fell by 14 percent in May to 1.7 million units from an impressive 1.9 million in April. Sales of new single family homes rose 10 percent in May, the highest reported increase since March 1984, but sales of existing homes fell in the same month. As for business fixed investment, planned expenditures on new plant and equipment for 1985 are slowly sinking with each successive survey. In real terms, spending on plant and equipment is expected to rise 6.2 percent this year, down from the 7.3 percent anticipated in the earlier survey. In the first quarter of 1985, such spending advanced only 1.1 percent on an annual basis. Further grim news from the business sector came when the National Association of Purchasing Managers composite index of business health in June was at its lowest level since December, 1982.

Like housing, the retail market is also sending off mixed signals about where it's been and where it's going. April data was revised upward to a 2.4 percent gain in sales, an extraordinary performance for a single month, but May's preliminary number, which is subject to substantial revision, registered a fall of 0.8 percent. June sales of domestic autos dropped to 7.6 million units at a seasonally adjusted annual rate, down from 8.4 million in May and 8.1 million in June a year ago. With both domestic and imported car sales down in June, it's likely that retail sales for the month will show little or no growth as well. The many factors that contribute to consumer sales give little reason to be optimistic about near term trends. Personal income fell in May, and in June, the Labor Department's household survey reported that the number of employed persons declined. Consumer sentiment fell 2.8 percent in May to the lowest level since 1983 and the Chamber's own Early Outlook Sales Survey, a nationwide compilation of retailers' attitudes, shows steady but modest deterioration since April. Not one respondent expected higher sales in the June survey. In recent months, much has been made of the growing consumer debt burden and the adverse impact this might have on future sales trends. So far this year, outstanding consumer installment debt has risen 23 percent at an annual rate compared to 20 percent last year. As a result, the ratio of outstanding installment debt to disposable income reached 17.9 percent in April, exceeding its previous peak of 17.8 percent reached in late 1979.

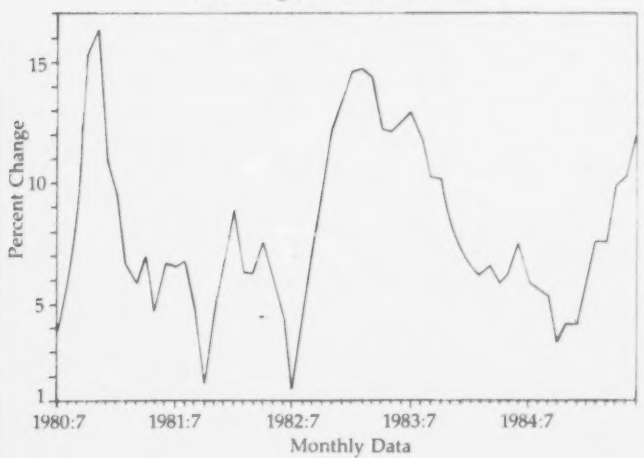
All in all, the list of mixed and pessimistic news is long and comprehensive and suggests that we have some real problems at the moment. Or does it? What we should bear in mind in watching these numbers is that they all largely reflect something that happened in the recent past, whereas our concern and interest lie in the future. In this respect, the attitudes that characterize the current situation are not much different from those that prevailed at the end of 1982 when the economy was poised to take off on the strongest recovery of the postwar era. What we have experienced for the past twelve months is a lengthy period of limited growth that fell well short of

the economic advance that characterized the preceding year and a half. Whether the economy has been level or declining, the economic situation, as evidenced by the monthly data releases, always appears at it bleakest at the end of such a period.

In assessing the prospects for a recession or an even longer period of stagnation, it is important to remember that recessions do not occur by chance or happenstance, but are the logical outcome of a period of severe economic adversity generally characterized by soaring inflation, rapidly rising interest rates, capacity constraints and a monetary policy deliberately designed to take the wind out of the economy. At the moment, none of these factors are present, although brief elements of some were prevalent in late 1984. Indeed, all of these factors are moving in a strong positive direction and should contribute to a reversal of the current period of drift during the second half of this year.

Inflation, of course, has been very well behaved through much of this recovery and shows no sign of moving up to the levels that would alarm policy makers and induce them to restrain the economy by putting the brakes on monetary growth. Interest rates have been falling since mid-1984 and are now as low as they've been since the late 1970s. And finally, after a prolonged period of restraint that probably contributed to the current lackluster economy, the money supply has been booming along at rates sure to stimulate economic growth (and maybe some inflation!) for the remainder of this year and part of next (see Chart 1).

CHART 1
Growth in the Money Supply (M-1)
(6-month growth rate, SAAR)



It is worth considering each of these factors in some detail because, as will be clear from the discussion, their behavior during 1984 may have had an important influence on the slow growth that we have experienced in the year to date. Consider what has happened with Federal Reserve policies and the behavior of the money supply since last year. In the first half of 1984, real GNP growth soared at exceptionally high rates of growth, causing the Federal Reserve and others to worry about an "overheated" economy (remember that one?). Inasmuch as the Fed's objective had become the "stabilization" of economic growth within a range that they believed was consistent with low inflation, it was only natural for them to adopt a policy of restraint in response to the economy's rapid growth in early 1984.

As the record shows, they did this with a vengeance. From June to December of 1984, there was essentially no growth in the money supply. Inasmuch as near-term economic activity is sensitive to the rate of change of the money supply, this policy of restraint, in effect for nearly half a year, contributed to a slowdown from which we are still suffering. Fortunately, this policy was changed in late 1984, but the damage was already done. Perhaps in response to the slowing, which became evident in late 1984, and out of concern that it may have been overdone, Federal Reserve policy rapidly reversed course and, in the all or nothing posture that we have come to expect from our central bank, the money supply has been growing by leaps and bounds (see Chart 1). From December 1984 to mid-June of this year, the money supply grew by 12 percent, an excessive rate by any standard. It is for this reason that we expect economic growth to advance at a reasonably rapid rate during the remainder of this year.

What we have here is a slightly less damaging, but no less disconcerting, version of the policy implementation process that has become typical of the Federal Reserve since the late 1960s. Having abandoned any attempt to engage in meaningful and consistent monetary targeting, the Fed has instead opted to act in a highly discretionary manner by trying to manage the course of the U.S. economy according to its own judgment of where the economy should be, where it is now, and where it might be in the next quarter or two. By leaning with or against the economy, the Fed exacerbates the economic ups and downs and, ultimately, ends up largely reacting to its own past policies as the economy teeters to and fro in response to the stop/go policies of the central bank.

In addition to the induced fluctuations in the economy, these erratic policies also contributed to wide swings in interest rates (see Chart 2). From a low point reached in early 1984, the entire spectrum of interest rates moved up sharply as the economy surged in response to the monetary stimulus and renewed fears of inflation. By July, shortly after the monetary brakes were applied, interest rates hit their peak and began to fall, with some rates reaching a six-year low by mid-1985. At the same time, the economy moved onto the plateau where it would remain for the next 12 months until the cycle begins anew in response to another dramatic reversal in monetary policy.

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1984-1986
Prepared by the U.S. Chamber of Commerce

Percent change from previous period at seasonally adjusted annual rates unless otherwise noted.

	QUARTERS									YEARS		
	Actual		Forecast							Actual	Forecast	
	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT												
Real GNP	4.2	0.3	3.8	5.0	4.7	4.3	3.5	3.5	2.8	6.8	3.1	4.1
Consumption	3.6	5.2	3.9	3.8	3.8	3.9	3.1	2.3	1.9	5.3	4.0	3.4
Residential Investment	-5.9	5.5	28.1	18.4	16.4	7.1	3.2	-1.2	-0.1	12.2	7.8	8.9
Business Fixed Investment	8.5	-1.5	9.6	11.6	11.7	10.5	8.0	11.2	7.3	19.8	8.0	10.2
Equipment	5.4	-5.6	9.4	13.7	13.2	12.2	9.0	13.5	7.9	21.5	7.2	11.7
Structures	17.1	9.8	10.0	6.6	8.1	6.0	5.3	5.4	5.7	15.6	10.3	6.5
Exports	-0.8	-8.9	5.4	6.5	5.5	6.3	6.2	6.1	6.0	4.7	0.5	6.0
Imports	-28.3	32.2	14.1	13.8	12.7	10.0	7.2	5.3	3.2	27.0	12.2	9.6
Change in Business Inventories (72$)	16.8	19.1	17.7	19.9	20.3	20.1	20.1	19.7	20.0	24.8	19.3	20.0
New Car Sales (mil. units)	10.3	10.9	10.6	10.9	11.2	11.5	11.7	11.7	11.9	10.4	10.9	11.7
Housing Starts (mil. units)	1.6	1.8	1.8	1.9	2.0	2.0	2.0	1.9	1.9	1.8	1.9	1.9
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.0	6.8	6.7	6.6	6.6	7.5	7.2	6.7
Compensation	3.5	5.4	4.1	4.2	4.3	4.8	4.4	4.4	4.4	4.2	4.4	4.4
Productivity	2.3	-2.6	2.6	2.3	2.9	2.2	2.1	2.0	2.0	2.7	0.9	2.4
Unit Labor Costs	1.3	8.3	1.4	1.9	1.5	2.6	2.3	2.4	2.5	1.4	3.5	2.0
Consumer Prices	3.5	3.3	3.9	3.5	3.8	3.9	3.9	3.9	4.0	4.3	3.6	3.8
GNP Deflator	2.8	5.4	3.4	3.1	3.2	3.1	3.2	3.1	3.2	3.8	3.8	3.2
Prime Interest Rate (%)	11.8	10.5	10.1	9.4	8.9	8.7	8.6	8.6	8.5	12.0	9.7	8.6
Profits from Current Production ($B)*	203.9	207.0	214.7	222.2	227.1	229.9	230.9	231.1	230.6	195.9	217.7	230.6
GOVERNMENT FISCAL POLICY ($B)**												
Unified Receipts										666	742	796
Unified Outlays										842	954	983
Unified Deficit										-176	-212	-187

*After-tax corporate profits with inventory valuation and capital consumption adjustments.

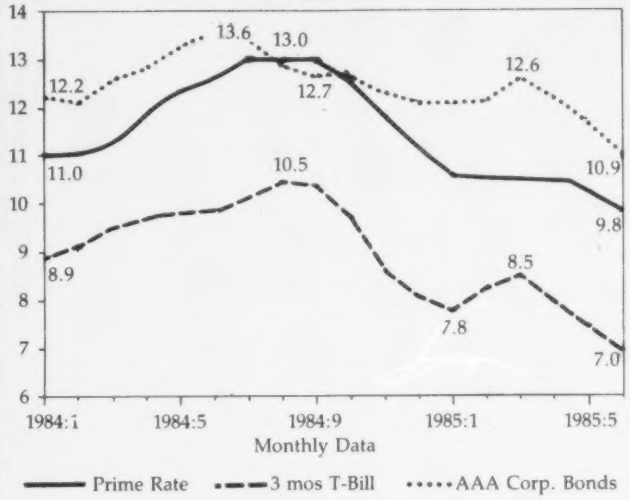
**Unified Budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University Macroeconometric Model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's third revision to the National Income and Product Accounts for the first quarter of 1985. It continues to take into account all the provisions of previously enacted legislation, including indexation of personal income tax rates. Congress is assumed to enact a deficit reduction package which results in a static reduction in federal government outlays of $50 billion in 1986. By then, unified budget outlays are 17 percent higher than they were in 1984. The nation's money supply, as measured by M(1), rises by 7.1 percent in 1985 and 5.8 percent in 1986. The federal minimum wage remains at $3.35 an hour throughout the forecast interval. The price of imported crude oil averages $27.8 in 1986 compared to $28.9 in 1984. The trade-weighted exchange value of the dollar falls by 2.2 percent by the fourth quarter of this year compared to the last quarter of 1984. During 1986, it falls an additional 6.6 percent.

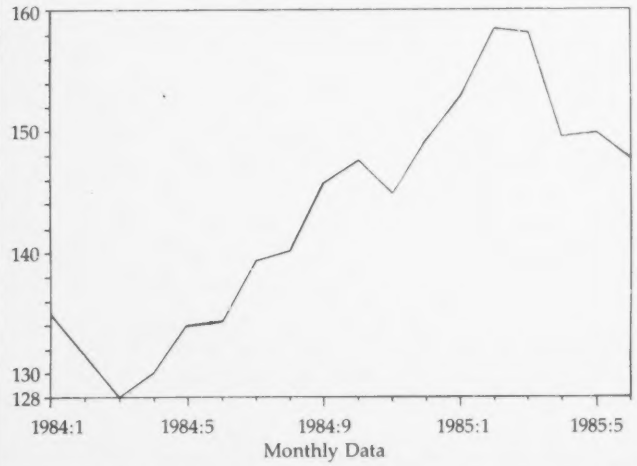
CHART 2
Interest Rates
(Percent)



Although the economy still appears to be stuck on this plateau, we are confident that the next six months will see fairly rapid growth in real GNP. Mixed in with all the bad news are some positive signs for the future. As a result of the interest rate decline, consumer buying intentions remain high and are within five percent of their peak values. Sixty-one percent of the respondents to the University of Michigan survey of buying intentions think that now is a good time to buy a house, and 65 percent think it is a good time to buy a car.

Despite the mixed picture in retail sales, consumer spending registered strong gains in both April and May as reported in the Department of Commerce's personal income series. This, in turn, has led to increased activity at the factory level. In May, household durable goods shipments rose by 6.8 percent. New orders for durable goods increased 4.1 percent, led by a 50.2 percent increase in defense goods and an 8.1 percent increase in household durable goods. The leading indicators also rose in May. Inflation remains low, and the recent declines in oil prices could ensure further near-term relief in energy prices. Finally, of importance to our beleaguered manufacturing sector, the value of dollar continues its steady fall on international exchange markets (see Chart 3). Since early March, the dollar has dropped 24 percent against the pound, 16 percent against the French franc and 15 percent against the German mark.

CHART 3
U.S. Dollar
(Trade weighted exchange value)



As the year progresses, we expect further positive indications of growth to emerge, leading to real GNP growth in excess of 4.5 percent for the remainder of this year. Beyond that, economic activity will depend on the Fed. Sooner or later, the Fed will have to curb the excessive monetary growth of the past seven months, and this could lead to another setback in 1986 if it elects to do this with the abruptness that characterized 1984 policies. Nonetheless, for the near term, we remain optimistic about the prospects for the economy.

TAX INCENTIVES AND THE RATE OF INVESTMENT

by
Ronald D. Utt

Over the past two years, we have frequently noted on these pages the extent to which business fixed investment has led this recovery by growing at a rate well in excess of previous postwar experience. Over the first ten quarters of this recovery, inflation-adjusted nonresidential fixed investment has increased by 30 percent. This is nearly twice the rate of increase in investment (16.4 percent) which characterized the five preceding postwar recoveries.

This boom in investment has gone far towards rebuilding our nation's capital stock and increasing the share of production devoted to future growth and productivity-enhancing investment such as new machinery, computers, factories and automated assembly lines. By the first quarter of 1985, this rapid growth in capital spending raised the share of inflation-adjusted gross domestic investment in our gross national product (GNP) to 12.8 percent. This share compares with an average of 9.8 percent by this point in the last six recoveries. Indeed, on an annual basis, real gross nonresidential investment averaged 12.5 percent in 1984, the highest share ever achieved in the past 24 years.

Some critics of the tax incentives have discounted the importance of these impressive figures by arguing that measures of performance that rely on *gross* investment figures are misleading and that a better measure of performance is *net* investment, which is equal to gross investment less depreciation. They then note that net invest-

ment has not done as well and that most of the investment that has taken place has been to replace the capital stock that has worn out or become obsolete as a consequence of rapid technological advance. According to this line of argument, we have added little to our capital stock during this decade.

While this may have been accurate in the earlier part of this expansion, data available through the first quarter of 1985 indicate that net investment is, in fact, advancing at a rapid rate. According to U. S. Chamber estimates, net investment increased by 139.5 percent between the end of 1982 and the beginning of 1985. This compares to an average gain of 45.8 percent in the five earlier recoveries that lasted this long. By the first quarter of 1985, net investment rose to 3.8 percent of GNP compared to an average of 3.0 percent by this point in the past five recoveries.

Role of Tax Incentives

In large part, these impressive gains in our investment performance are directly related to the Economic Recovery Tax Act of 1981 which substantially increased the incentives for businesses and individuals to increase their rate of investment in new factories, office buildings and capital equipment. The combination of the Accelerated Cost Recovery System (ACRS), with its rapid write offs over a shorter period of time, and the Investment Tax Credit (ITC) greatly reduced the cost of capital to business and encouraged the investment boom. Although the anecdotal evidence from the past few years suggests that the tax law changes were responsible for this rapid rate of investment, the availability of more than three years of experience with the system has enabled scholars to carefully evaluate the results to determine the extent to which these tax changes have contributed to our impressive investment performance.

In a detailed econometric study of investment incentives performed for the National Chamber Foundation, Dr. Michael Boskin of Stanford University estimates that "ACRS and the ITC was responsible for about 25 percent of the net investment in the 1982 - 1984 period." In turn, this increase in investment contributed to a $79 billion gain in the GNP between 1982 and 1985. An earlier study by Leonard Sahling and M.A. Akhtar of the Federal Reserve Bank of New York came to a similar conclusion regarding the Economic Recovery Tax Act of 1981. Whereas Boskin only considered the effects of ACRS and the ITC, Sahling and Akhtar considered all of the tax changes, including the lower rates for individuals, and found that the combined effects of ERTA accounted for 40 percent of the increase in investent in producers' durable equipment during this recovery.

All in all, there is every reason to believe that ERTA contributed to a much needed boom in capital spending and that the economy is much better off as a consequence. But with Congress and the Administration contemplating major alterations to the tax code which would generally diminish the incentives to invest, the question we must consider is whether we can now claim victory in our goal of improving U.S. investment performance, and accept something less for the future. While the tremendous boom we have experienced suggests to some that our capital investment problem has been resolved and that a pause is something that we could comfortably afford to accept as the necessary price for comprehensive tax reform, a closer inspection of the investment data from the past several years suggests that a number of weak spots remain and that we still have a long way to go before we can consider the problem resolved.

Uneven Performance

The first source of concern becomes readily apparent when the investment trend of the past several years is broken up into its component parts. Then, it becomes apparent that only a few types of producers' durable equipment accounted for most of the investment boom and that business investment in many other types of capital equipment have yet to reach the levels achieved in 1979. Table 1, which ranks twenty types of producers' durable equipment by the amount spent upon each in 1984, shows that for thirteen of the twenty investment types, business spending, after adjustment for inflation, actually declined between 1979 and 1984.

TABLE 1
TYPES OF PRODUCERS' DURABLE EQUIPMENT RANKED BY CONSTANT DOLLAR INVESTMENT IN 1984

Equipment Type	1979 Investment ($ Billions)	1984 Investment ($ Billions)
Office, computing and accounting machinery	$16.2	$39.4
Electrical and communications equipment	19.9	24.2
Autos	10.1	16.9
Trucks, buses, & truck trailers	13.8	12.7
Instruments	9.6	12.7
Furniture and fixtures	4.0	5.3
General industrial equipment	6.1	4.9
Metalworking machinery	6.3	4.8
Special industry machinery	4.4	4.8
Fabricated metal products	3.8	3.7
Other miscellaneous	3.4	3.0
Service industry machinery	3.3	3.0
Aircraft	2.9	2.4
Mining and oilfield machinery	1.7	2.3
Construction machinery	4.2	2.1
Tractors	2.7	2.0
Agricultural machinery	3.9	1.6
Engines and turbines	1.4	1.1
Railroad equipment	2.6	1.0
Ships and boats	1.3	0.6

Source: Department of Commerce and Machinery and Allied Products Institute

Reflecting the rapid gains in technology and the office automation boom, the table demonstrates that fully 85 percent of the increase in producers' durable equipment over the first half of this decade was accounted for by the increase in investment in office, computing and accounting machinery, which more than doubled over the period. In effect, the great bulk of the recent surge in investment has gone into the rapidly growing service sector. Manufacturing, in contrast, still lags behind and has yet to fully participate in the investment boom. (See the companion article, this issue, for a complete discussion of the U.S. manufacturing sector.) Should this weak investment performance persist, our manufacturing sector will continue to be under competitive pressure from abroad, industrial production will remain stagnant, more jobs will be lost, and the trade deficit will widen.

The lackluster investment performance of the manufacturing sector shows up clearly in the relative differences in productivity growth in the manufacturing sectors of the leading industrialized countries. Table 2 compares the U.S. productivity performance with that of nine other countries. Note that while we have certainly improved our performance in recent years, our productivity growth rate still falls short of most of our competitors'. In 1984, Japanese manufacturing productivity growth was nearly triple ours, thus continuing the trend of the last dozen years which has allowed them to successfully penetrate our markets at the expense of our less efficient domestic producers. Unless this vast difference in relative productivity growth is narrowed, foreign producers will continue to make inroads into our economy, and our industrial base will suffer accordingly.

TABLE 2
MANUFACTURING PRODUCTIVITY

Country	Output per hour (percent change) 1973-84	1983	1984
United States	2.0%	4.3%	3.5%
Canada	1.7	6.4	4.0
Japan	7.3	5.1	9.5
Denmark	3.6	3.0	4.1
France	4.6	4.3	5.0
Germany	3.3	4.7	4.7
Italy	3.7	2.4	6.3
Norway	2.3	5.9	1.7
Sweden	2.9	8.4	6.8
United Kingdom	2.3	6.7	3.9

Source: U.S. Department of Labor

Potential Impact of Tax Reform

Despite this apparent risk, the Administration's most recent tax reform proposal would further diminish the investment tax incentives and, according to several econometric studies, contribute to a decline in the rate of investment over the foreseeable future. In a study of the new proposal presented in testimony to the Ways and Means Committee, Dr. Joel Prakken of Washington University estimates that the combined effects of the new tax plan would be to raise the rental price of producers' durable equipment by about ten percent. Given this higher cost, Prakken's analysis finds that investment in equipment will fall by more than any other category of investment. Other analysts have conducted similar studies and all conclude that investment in producers' durable equipment will be less under the new tax proposal than what would otherwise occur under current law. Table 3 presents the findings of these studies from three major models of the economy.

TABLE 3
CCRS IMPACT ON REAL INVESTMENT IN PRODUCER'S DURABLE EQUIPMENT
(percent difference)[a]

Model	1986	1987	1988	1989	1990
Data Resources, Inc.	+0.3	−1.5	−1.9	−1.9	−1.4
Washington University	−4.1	−5.1	−5.2	−4.8	−3.8
Chase Econometrics	−4.8	−1.0	−0.6	−1.4	−2.6

[a]Shows the difference in percentage terms, between the anticipated level of investment in PDE under the Administration's tax reform plan, and what would otherwise have been the likely path of PDE investment.

According to these models, the enactment of the Treasury's proposed Capital Cost Recovery System, which is to replace ACRS and the ITC, will lead to a decline in spending on producers' durable equipment (from what would otherwise have been the likely path of PDE investment), ranging anywhere from slightly more than one percent to as high as five percent per year over the remainder of the decade. Although the percentages are small, they amount to billions of dollars of lost spending on new investment. Without this investment, the economy will grow more slowly, productivity growth will diminish and our competitive position in the world economy will be at risk.

U.S. MANUFACTURING IS ALIVE AND WELL

by
Rajni Bonnie Ohri

Over the past few years, concern regarding the "deindustrialization" of the American economy has escalated, prompting some to advocate government intervention to stem the decline. Judged by criteria such as overall eco-

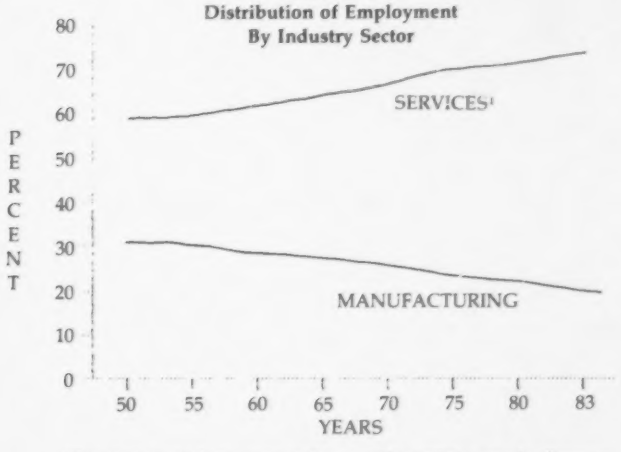
nomic growth, capital formation, productivity, profitability, and international competitiveness, the U.S. appeared to have entered a period of secular decline in the 1970s. This situation was further aggravated during the prolonged period of stagnation beginning in 1979 and the back to back recessions of 1980 and 1981-82. However, a careful analysis of the data shows that the U.S. manufacturing sector is *not* in a state of precipitous decline, as industrial policy advocates maintain.

This article examines the data for manufacturing output and employment to test the assertion that the U.S. economy is "deindustrializing". The results, however, suggest that what is occurring is not an across-the-board decline in manufacturing activity. Rather, we are experiencing a significant shift of resources towards high-productivity industries which are better able to compete both domestically and internationally, at the expense of a few industrial sectors which are hard-pressed by foreign competition.

Employment in Manufacturing

The contribution of manufacturing to the output of the economy has remained relatively stable over the past two decades, even as service-producing industries have become more important. Continuous economic change, however, has redistributed the labor force among major industrial sectors. Although in absolute terms manufacturing employment grew during the past two decades, its relative share of total employment declined (see Chart 1). A popular claim made by industrial policy proponents is that employment in manufacturing has fallen sharply, forcing large numbers of workers into low-paying service sector jobs. However, the data shows that there has been a rise, not a decline, in manufacturing employment over the past several decades – from 16.8 million workers employed in 1960 to 19.4 million in 1970 and 20.3 million in 1980. Further, since the current recovery began in November 1982, 1.4 million new jobs have been created in the manufacturing sector, representing over 16 percent of total job creation in the U.S. economy. And, the Bureau of Labor Statistics estimates that manufacturing employment will continue to increase through 1990.

CHART 1
Distribution of Employment
By Industry Sector



[1]Services include transportation, public utilities, trade, finance, insurance and real estate services, government, and miscellaneous.

Source: Bureau of Labor Statistics

Within the manufacturing sector, however, gains and losses have been distributed unevenly among industries. Some industries, such as basic steel and mill products, have declined in terms of both output and employment over the past several years. But others, such as communications equipment, electronic components, office and computing machines, have grown impressively (see Table 1). This reflects a substantial shift in employment among industries within the manufacturing sector from low productivity industries to the more productive high-tech industries. Moreover, the spread of high-technology manufacturing will continue to give an important boost to a group of services closely linked to manufacturing – consulting, data processing and engineering, among them.

TABLE 1
TEN INDUSTRIES WITH LARGEST EMPLOYMENT GAINS ABOVE PRE-1980 RECESSION PEAK
(seasonally adjusted)

Industry Title	Employment Gain (in thousands)
Communication equipment	119
Electronic components and accessories	1[illegible]0
Office and computing machines	102
Commercial printing	71
Miscellaneous plastics products	71
Guided missiles, space vehicles	68
Newspapers	27
Motor vehicles and equipment	24
Periodicals	21
Miscellaneous publishing	21
TOTAL	643

Source: Bureau of Labor Statistics

Trade and its Affects on Industry Employment

The widespread publicity afforded the current import pressures faced in the automobile, steel, textile and shoe industries has contributed to the mistaken impression that America is being flooded by a tide of foreign imports. Examination of the data reveals, however, that this apprehension may be exaggerated. A New York Stock Exchange study, *U.S. International Competitiveness: Perception and Reality,* reviewed 40 major manufacturing industries, and found that the volume of imports grew less than five percent per year between 1977 and 1983 in 16 industry groups, and less than ten percent per year in 21 other groups. In another nine industry groups the volume of imports actually declined.

The same study estimated that, in 1982, foreign trade resulted in a net loss of 584,000 U.S. manufacturing jobs, that is, 584,000 more manufacturing jobs were taken away from Americans by foreign imports than were created by U.S. exports. However, this loss represents less than three percent of all manufacturing jobs and was concentrated in four industries: apparel, motor vehicles, shoes and leather, and iron and steel. Further, the losses experienced by these industries were counterbalanced by major job gains in computers, aerospace, construction, mining and oilfield equipment. In fact, aside from these four industries, foreign trade accounted for a net addition of 64,000 manufacturing jobs in 1982.

There is no doubt that the loss of competitiveness during the 1970s was a serious problem for some industries, but the source of the problem was primarily domestic. Without increased trade, the growth in U.S. employment during the 1970s would have been much less robust. Many studies have attempted to estimate the number of jobs lost as a result of increased imports of manufactured products, but the task is not easy. Jobs lost will depend on the labor intensity of the products being displaced and on the indirect effect on employment in industries supplying the directly affected industry. In any case, job displacement should be measured against job creation by expanded exports of manufactured products to our trading partners.

Trends in Manufacturing Output

An analysis of output trends for key sectors of the American economy reveals some interesting results about the underlying strengths of industry. During the 1981-82 recession, total durable goods production declined by 11 percent; smaller declines occurred in the broader aggregates, such as total manufacturing and industrial production (see Table 2). All three aggregate measures, however, remain substantially above the levels of the 1970s.

Looking at the individual industry groups shows a more diverse pattern of movement. For example, primary metals (including steel) took a tumble, declining by 31 percent between 1981 and 1982. In contrast, transportation equipment fell by only nine percent, and instrument producers reported a five percent drop in output. However, of greater interest is the nature of the snapback in 1983. Two industry groups, electrical machinery and transportation equipment, exceeded their 1981 highs. At the other end of the spectrum of performance, the 1983 recovery in primary metals (up 13 percent) did not return that industry to its 1975 level of output. Nevertheless, taking full account of the variations among industries, it seems clear that the decline in heavy manufacturing industries that was so noticeable in 1982 did not represent a new and durable long-term trend. Rather, the decline was primarily the result of a severe, but short-term cyclical contraction.

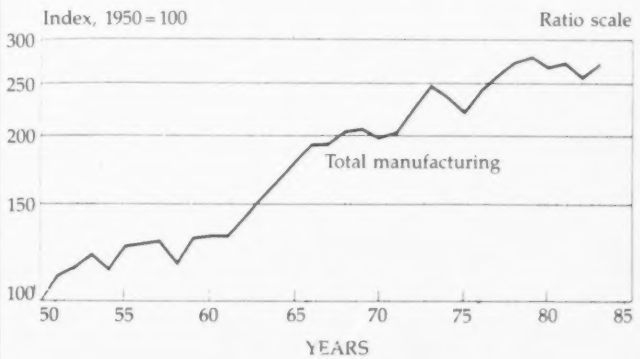
TABLE 2
PRODUCTION INDEX FOR SELECTED DURABLE GOODS MANUFACTURING INDUSTRIES
(1967 = 100)

Industry Group	1970	1975	1980	1981	1082	1983	Dec. 1983	May 1985
Primary Metals	107	96	102	108	75	85	90	97
Fabricated metal products	102	110	134	136	115	120	129	141
Electrical machinery	108	117	173	178	169	186	201	216
Nonelectrical machinery	104	125	163	171	149	151	164	189
Transportation equipment	90	97	117	116	105	118	131	146
Instruments	112	132	171	170	162	159	165	179
Total Durable Goods	102	109	137	141	125	135	145	158
All Manufacturing	106	116	147	150	138	148	157	167
Total Industrial Production	108	118	147	151	139	148	156	165

Source: Federal Reserve Bulletin, various issues.

Manufacturing output made an impressive recovery in 1984, rising by nearly 12 percent, compared with 1983, thanks to large gains in the high-tech and sophisticated equipment industries (see Chart 2). In a recent report on the manufacturing sector, Data Resources, Inc. (DRI) predicted that the growth of the computer, telecommunications, biotechnology and factory automation sectors will more than offset declines in older, basic industries, such as steel products, permitting manufacturing to hold on to the same share of the nation's economy it now has. Manufacturing output has continued to account for about one-quarter of the total output of the economy throughout the postwar period.

CHART 2
Output in Manufacturing[1]



[1]Gross product originating in manufacturing, constant dollars.

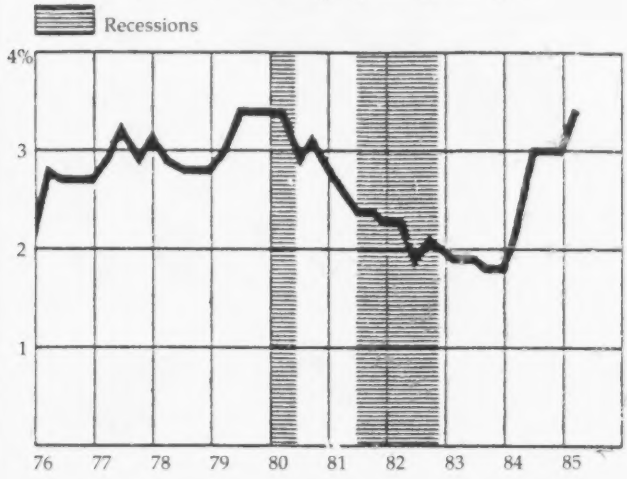
Source: Bureau of Labor Statistics

The point to be emphasized here is that our experience during the past decade has been typical of economic swings associated with the business cycle. For some industries these swings have been severe, but on reflection, when the economy goes through a recession, it is not surprising to see a disproportionate decline in manufacturing industries. The other side of the coin, however, is that during the economic recovery of 1983 and 1984, these same industries recovered from the recession more rapidly than the rest of the economy. Thus, the current data do not support the pessimistic prediction that our manufacturing sector is in a decline.

Growth of Manufacturing Capacity

Since 1976, overall manufacturing capacity has risen by 27 percent. During the first quarter of 1985 the rate of growth in capacity rose by 3.2 percent, the fastest quarterly growth rate since 1976 (see Chart 3). Over that period, as Chart 4 shows, capacity in some industries—chemicals, rubber, plastics—has soared. In some others, to be sure, there was relatively little gain, and in one extreme case—iron and steel—capacity actually declined.

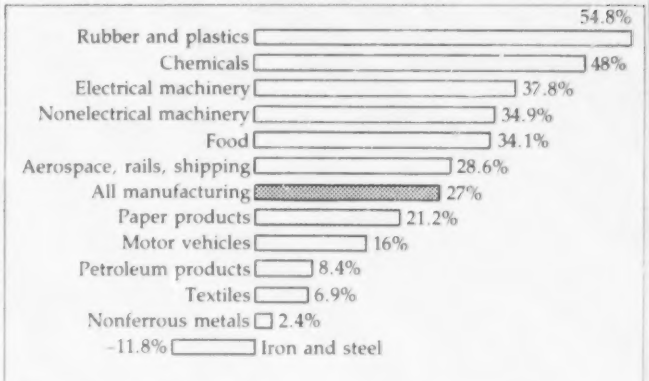
CHART 3
Growth of Manufacturing Capacity
(Annual rate of change, plotted quarterly)



Source: Federal Reserve Board and Department of Commerce.

However, as Chart 3 shows, the surge in the rate of growth of factory capacity largely reflects an exceptional rise in investment since the last recession. Analysts attribute this not only to an unusually low investment rate in that recession, but also to various tax incentives implemented in recent years to spur capital outlays. These include increases in the investment tax credit, an accelerated cost-recovery system that shortens the write-off period for plant and equipment, and a new tax credit for research and development. Looking ahead, a recent survey of more than 500 companies by McGraw-Hill Inc. finds that manufacturers' 1985 outlays aimed specifically at expanding production capacity will lead to a five percent rise in physical capacity this year and next.

CHART 4
Change in Capacity
(since 1976, by industry)



Source: Federal Reserve Board.

In some industries, the rise in productive capacity has also resulted from striking technological advances that have little to do with building new factories or new production lines. In the chemical industry, new catalysts can raise an old plant's output by as much as 400 percent without any new equipment. General Electric now makes 2,000 versions of its basic electric meter at a single small plant. And, in the textile industry, lasers inspect 10,000 yards of cloth an hour—15 times faster than a human once could.

In addition, foreign competition is forcing some industries to spend more on equipment, which will ultimately reduce costs and increase productivity. The need to modernize in order to remain competitive has become paramount. One of the best examples of the changes in the manufacturing industry is Cleveland-based Eaton Corp. which has streamlined operations, strengthened its balance sheet, tightened quality standards, and shed ailing businesses to lower costs. Also, Deere and Company's tractor works facility includes totally automated machines and conveyors linked to a computer; it can now turn out tractors in more than 5,000 configurations.

U.S. Industry Will Survive

The health of an industry is determined not by its demand for inputs but by its supply of output, i.e., by its contribution of goods and services to society's standard of living. Between 1950 and 1983, manufacturing output increased by 170 percent while manufacturing employment rose by 21 percent. But increases in manufacturing output without equal increases in manufacturing jobs are not a sign of weakness. Instead, they signify higher productivity and as a result, higher living standards. In fact, during the same period, manufacturing productivity increased by 126 percent.

Indeed, the data reveals that in each of the past six recoveries, a higher level of manufacturing output has been attained with fewer workers. For example, twenty months after the recent recovery began, industrial production was 23 percent above the level of output at the trough of the recession, and 7.9 percent above the all-time high for this index. Yet, with all this spurt in production the actual number of persons employed in the manufacturing sector was still 1.7 million workers below the level of 1979, when industrial production was 7.3 percent lower than it is today.

In addition, productivity has advanced in almost all manufacturing industries since the 1960s. In general, relatively brisk productivity advances within manufacturing industries have served to boost business productivity overall. Last year, for example, the hourly output of manufacturing workers rose 3.5 percent, while the hourly output of workers in all businesses, including services, increased by only 2.3 percent.

Conclusion

It appears that much of the concern about the decline of the U.S. manufacturing sector stems from the unfortunate tendency to extrapolate the experiences of a relatively small number of industries which have hit upon hard times. These include the following industry groups: motor vehicles, iron and steel, shoes and leather, apparel, textiles and knitting. Yet, a close examination of the output and employment data of these troubled industries shows that they are not representative of the entire manufacturing sector.

According to the New York Stock Exchange study referred to previously, these six industries combined accounted for only 4.5 percent of total employment and 5.6 percent of total output in 1977. By 1983, their respective shares had fallen to 3.9 percent and four percent. In addition, during the period 1977-83, employment in these six industries declined by 17 percent and the value of their combined output also fell by 14 percent. However, the remaining manufacturing industries, which account for four-fifths of total manufacturing output, (the total less the six troubled industries) performed much better during the same period, employment rose by six percent and output increased by 14 percent. These data make it clear that despite some very troubled industries, on the whole, the manufacturing sector has not performed badly.

In sum, what is occurring within the manufacturing sector is a gradual but significant shift of capital and labor resources toward industries with higher productivity and away from industries employing less skilled labor. During the process of industrial restructuring, traditional industries such as steel, automobiles and textiles have become less important sources of employment, but this does not imply that basic industries will no longer be significant to the economy. Although the output of these industries may grow more slowly, resources will gradually shift toward high-skill, high-technology types of production within each industry. Indeed, the decline of output and employment in these traditional industries has been neither large nor rapid, and the overall growth of the manufacturing sector demonstrates that the industrial base is changing its composition, not declining in importance.

TRENDS IN COMMERCE NOTES ON TABLE II JULY, 1985

by
Martin Lefkowitz

Beginning with this month's issue, the *Trends In Commerce* summary will include three additional indicators designed to measure economic activity in the services sector. Most of the closely followed gauges of the U.S. economy are measures of activity in the goods-producing sector and tend to ignore services – the fastest growing sector. For instance, indicators such as industrial production, housing starts, and retail sales all measure economic activity in the goods sector. The leading economic indicators, a gauge of future trends in the economy, is heavily weighted in the direction of the goods sector. The leading index includes such indicators as the average workweek in manufacturing, new orders for manufactured goods, vendor performance on delivery of goods, orders for new plant and equipment, change in business inventories and building permits. Even in the stock market, the most closely watched indicator is the Dow Jones Industrial Average. The reported data on international trade also show an obsession with the merchandise trade deficit, tending to ignore the fact that the U.S. runs a surplus in trade in services.

It is because of this benign neglect that we are now adding three indicators of services sector activity and will seek to expand this section in the future. The three new series that appear in this month's summary of economic trends are: (1) consumer purchases of services, (2) revenue passenger miles flown by major U.S. airlines, and (3) service sector employment. The definition of services that we will use is the standard national accounting concept of services, that is, all output not accounted for by the four goods-producing sectors of the economy (agriculture, mining, manufacturing, and construction), are allocated to services.

Gross National Product (GNP) – The Department of Commerce's revised estimate of the nation's economic performance as measured by the Gross National Product – the value of the output of goods and services – indicates that the inflation-adjusted growth rate in the second quarter picked up to a seasonally adjusted annual rate of

3.1 percent. The data continues to indicate that personal consumption and business investment are growing rapidly, with residential investment and government purchases showing smaller gains. It appears that businesses were living off their inventories in the second quarter. This should boost economic growth later in the year as depleted inventories are replaced. The first quarter growth rate of 0.3 percent now being reported is about one-seventh the 2.1 percent growth rate estimated in the flash forecast issued in March.

The Services Sector– The service industries continue to be the growth sector of the economy. Comparisons between growth in services and recent growth in goods underscore the dramatic differences in the trends. Employment in service sector establishments rose by 0.5 percent in May and is now 4.5 percent above its year-ago level. This compares with no change in employment in the goods producing sector in May and a 1.7 percent increase in the last year.

Consumers continued to increase spending on services despite a lackluster performance in the goods sector. May data indicate that while retail sales were declining by 0.8 percent for the month, consumer expenditures on services soared by 0.7 percent. In addition, consumer purchases of services were up 8.8 percent from a year ago compared to an increase in retail sales of 5.3 percent from last May. Consumer purchases of services now comprise 50.4 percent of personal consumption expenditures. This compares to 1984 when services accounted for 49.3 percent of personal consumption expenditures. One of the services getting an increasing share of the consumer dollar has been travel. Revenue passenger miles flown, that is the number of passengers multiplied by the miles flown by each passenger, increased 5.3 percent in May from April and was up nearly 15 percent from its level of last May.

Money Supply–The nation's money supply–as measured by M-1, currency in circulation plus demand deposits–increased by 1.2 percent in May, about twice the rate of growth in March and April. The money supply, in the latest three-month period, has been growing at an 8.5 percent seasonally adjusted annual rate, above the Federal Reserve's target range of 4 to 7 percent.

Employment–The civilian unemployment rate remained unchanged at 7.3 percent in June for the fifth month in a row. Civilian employment–as measured by the monthly survey of households–decreased by 590,000 persons (seasonally adjusted). However, the number of jobs in June, before seasonal adjustment, increased by almost one million. The reason for the stagnant rate of unemployment is the continued flow of new entrants and reentrants into the labor force that swells the ranks of the unemployed. On the other hand, the number of nonagricultural payroll jobs–as measured by the monthly survey of business establishments–increased by nearly 900,000 since February, reflecting the continued strength of service sector and construction employment.

Prices–The Consumer Price Index for all urban consumers (CPI-U) increased 0.2 percent in May, following a 0.4 percent increase in April. The index for May showed that prices for food, clothes and transportation declined, while the price of housing rose substantially. The transportation index declined due to smaller increases in gasoline prices. The lifting of the import restrictions on Japanese cars has resulted in lower prices for both new and used cars.

Wholesale prices of finished goods were unchanged in June from May and were up only 1.1 percent from their year ago level. This followed three consecutive monthly increases in wholesale prices. The index for energy prices turned down after substantial increases in April and May, while capital equipment prices were up 0.4 percent after two months of remaining unchanged. From June 1984 to June 1985, the finished goods index increased by only 1.1 percent. This increase is less than one-third the 3.7 percent increase in consumer prices in the last twelve months, reflecting the fact that the Producer Price Index only measures the goods sector of the economy while the the Consumer Price Index measures both goods and services.

Producer prices of crude goods declined in June for the seventh consecutive month. The June decline of 0.6 percent in crude materials prices was the smallest price drop during the year within this volatile sector. Crude materials prices in June were 8.3 percent below their levels of a year ago. Crude food and feedstuff prices have now declined 10.1 percent in the last year.

Housing Starts–Housing starts plunged 13.7 percent in May to 1,663,000 units from a revised 1,927,000 units (seasonally adjusted annual rate) in April. The April starts were the best level for any one month in a year. The drop in starts was viewed as a statistical fluke by many economists in light of the decline in interest rates which has lowered the cost of home ownership and increased the affordability of new homes. In addition, building permits, usually an indicator of future activity in the home building industry, continued to rise in May, and new home sales were up by 9.7 percent, indicating demand is responding to the recent interest rate declines.

Industrial Production–Industrial production fell 0.1 percent in May, following a 0.2 percent decline in April. The two sectors that continued to register strong gains were defense and space products, and construction supplies. Production of consumer goods was unchanged in May, reflecting a small decline in the output of home goods and little change in automotive production. Business equipment production declined in May for the fifth consecutive month, but remained six percent above the level of April 1984.

The capacity utilization rate for manufacturing decreased 0.3 percentage points in May as factories operated at 80.4 percent of capacity. The sector suffering the largest decline was electrical machinery, with the utilization rate declining from 86.5 percent to 85.2 percent of capacity. The largest gain among major manufacturing industries was a 0.4 percentage point increase in the utilization rate for motor vehicles and parts. Manufacturing capacity increased 0.8 percent in the first quarter of 1985 and was 3.1 percent above the first quarter of 1984.

Productivity—Nonfarm business productivity fell at a 2.5 percent annual rate in the first quarter, compared with a preliminary estimate of 1.2 percent. The decline was the most severe since the fourth quarter of 1981, when it dropped 4.4 percent. The productivity decline resulted from an increase of over 800,000 jobs in the first quarter (which amounted to a three percent annual rate of growth in employment), while the economy was growing at a much slower rate. The revision in the productivity number can also be attributed to the downward revision of the GNP data. Output was essentially flat while hours worked by employees increased at an adjusted 3.3 percent rate, the biggest jump since the second quarter of last year. The combined effect of employees' working longer hours and producing less caused unit prices in the nonfarm sector to soar at an adjusted annual rate of 8.1 percent.

Interest Rates—At 9.5 percent, the prime interest rate is 3.5 percentage points below last summer's peak, and out of the double digit range for the first time in nearly seven years. The reduction in the prime rate reflected the lower cost of funds to the banks. In the last three months, the Federal Funds rate has declined 162 basis points with other short-term rates showing similar declines. During that same period, money supply (M1) growth has accelerated to an 11.7 percent annual rate.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failures indicates that business failures declined in mid-June and were at their lowest level since March. The index of business failures, which uses October 1983 as a base of 100, decreased to 103.1 in the week ending June 7, 1985. In addition, business discontinuances and business closings were also trending downward in early June.

Dun and Bradstreet reported that 635,000 new business corporations were formed in 1984, an increase of 5.8 percent from the previous year. Fifteen states had increases of 10 percent or more, and eight of the nine census regions reported more new business corporations formed in 1984 compared to 1983. The only region reporting a decrease in business corporations was the West South Central, while the New England region reported the largest annual gain with an increase of 11.5 percent in 1984, twice the national average. The states reporting the largest increases in new corporations for 1984 were Vermont, Georgia, and South Carolina. The number of new business corporations formed in December 1984 was 53,305 (seasonally adjusted), 3.8 percent more than the same month a year earlier. Ten states registered increases of more than 10 percent from their year-ago levels in December, with Vermont, New Jersey and Arizona reporting the largest increases.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased 12.4 percent in May from its year-ago level. In the first eight months of fiscal 1985, federal expenditures increased by 12.2 percent, three times as fast as prices, indicating a real increase in federal spending of about eight percent from the year-ago level. Federal receipts, during the same period, have risen by 12.5 percent as a result of increases in personal income taxes, corporate income taxes, and social insurance taxes. The data on tax receipts indicates that the deficit is the result of excessive growth in federal outlays rather than the 1981 tax cuts.

Personal Savings—Personal savings increased from 4.5 percent of after-tax income in the first quarter to 5.3 percent of after-tax income in the second quarter of 1985. The reason for the increase in the savings rate in the second quarter was that the tax refunds that were delayed in the first quarter of the year finally reached consumers in the second quarter. The impact of the IRS tax refund delays on savings and income were particularly visible in the monthly data as consumers nearly doubled their savings from an annual rate of $94.6 billion in March, when refund checks were being delayed, to $182.5 billion in May, after refunds were received. The delays in the refunds reduced after-tax income by $6.7 billion in February and March, which, when translated into seasonally adjusted annual rates, amounts to over $40 billion, on average, for each of the two months.

Retail Sales—Retail sales declined 0.8 percent in June, but were still up 6.0 percent in the latest three-month period. June retail sales were 4.4 percent above the level of a year ago, indicating that inflation-adjusted retail sales are up about two percent from year-ago levels. Durable goods sales fell 2.1 percent in June, after declining 1.0 percent in May; nondurable goods sales remained unchanged in June after declining 0.1 percent in May.

Trade Deficit—The trade deficit, on a goods and services basis, increased to $74 billion in the first quarter from $56 billion in the fourth quarter of 1984. The deterioration is largely the result of an $11.6 billion increase in imports, while exports decreased by only $3.4 billion in the first quarter. On a monthly basis, the merchandise trade deficit rose by $800 million in May to $12.7 billion, the largest single-month deficit since July 1984. Petroleum imports in May declined 1.1 percent, but this was offset by increases in imports of organic chemicals, clothing, and aircraft. Imports of automobiles from Canada increased,

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Apr/85	238.4	238.3	236.3	0.1	0.9
Gross National Product ($B)	II/85	3,870.2	3,810.6	3,644.7	1.6	6.2
Gross National Product (72$B)	II/85	1,676.2	1,663.5	1,638.8	0.8	2.3
Money Supply (M1) ($B)	May/85	581.6	574.9	542.5	1.2	7.2
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	May/85	2,492.8	2,474.5	2,340.1	0.7	6.5
Personal Consumption Expenditures (72$B)	Apr/85	1,098.0	1,088.2	1,053.9	0.9	4.2
Disposable Personal Income ($B)	May/85	2,768.8	2,724.2	2,549.2	1.6	8.6
Disposable Personal Income (72$)	Apr/85	1,208.8	1,170.7	1,160.4	3.3	4.2
Personal Savings Rate (%)	Apr/85	5.3	4.5	6.1	0.8[b]	−0.8[b]
Civilian Employment (millions)	Jun/85	106.4	107.0	105.4	−0.6	0.9
Civilian Unemployment Rate (%)	Jun/85	7.3	7.3	7.2	0.0[b]	0.1[b]
Average Hourly Earnings	May/85	$8.55	$8.54	$8.29	0.1	3.2
Consumer Price Index (All Urban, 67 = 100) [a]	May/85	321.3	320.1	309.8	0.2	3.7
Purchasing Power of the Dollar (67 = $1.00) [a]	Apr/85	0.311	0.312	0.323	−0.218	−3.55
Prime Interest Rate (%) July 9, 1985		9.5	10.0	13.0	−0.5[b]	3.5[b]
Retail Sales ($)	Jun/85	113.9	114.8	109.1	−0.8	4.4
SERVICES SECTOR						
Employment in Services (Millions)	May/85	72.4	72.0	69.3	0.5	4.5
Consumer Purchases of Service ($B)	May/85	1,251.5	1,242.4	1,154.8	0.7	8.8
Consumer Purchases of Service (72$B)	Apr/85	504.7	503.9	487.2	0.2	3.6
Revenue Passenger Mileage Flown Major Airlines (Millions) [a]	May/85	26,610	25,269	23,204	5.3	14.7
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits ($B) [a]						
Before Tax [a]	I/85	222.3	228.7	243.3	−2.8	−8.6
After Tax [a]	I/85	137.0	141.0	150.6	−2.8	−9.0
Industrial Production (67 = 100)	May/85	165.3	165.5	162.8	−0.1	1.5
Capacity Utilization Rate (Mfg.) (%)	May/85	80.4	80.7	81.7	−0.3[b]	−1.3[b]
New Housing Starts (thou. units)	May/85	1,663.0	1,927.0	1,787.0	−13.7	−6.9
Net Business Formation (67 = 100) [a]	May/85	112.2	115.4	115.7	−2.8	−3.0
New Business Incorporations (Thousands)	Dec/84	53.5	53.5	51.6	0.0	3.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	I/85	163.2	160.0	158.3	2.0	3.1
Unit Nonlabor Costs (77 = 100)	I/85	157.6	155.0	152.5	1.7	3.3
Producer Price Indices (67 = 100)						
Crude Materials	Jun/85	305.5	310.0	333.2	−0.6	−8.3
Intermediate Goods	Jun/85	320.2	319.9	321.5	0.0	−0.4
Finished Goods	Jun/85	294.0	294.2	290.8	0.0	1.1
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	May/85	611.0	626.1	543.6	−2.4	12.4
Federal Government Debt Outstanding ($B) [a]	Mar/85	1,715.1	1,702.8	1,468.3	0.7	16.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/85	360.7	367.2	358.9	−1.8	0.5
Imports of Goods & Services ($B)	I/85	435.2	423.2	410.4	2.8	6.0
Balance on Goods & Services ($B)	I/85	−74.5	−56.0	−51.5	33.0	44.7
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	May/85	167.8	166.6	168.2	0.7	−0.2

NOTES: All data seasonally adjusted unless otherwise noted
[a] Not seasonally adjusted
[b] Percentage point difference

while Japanese auto imports declined for the month. May exports declined in agricultural commodities, autos and power generating equipment. However, exports of aircraft, electric machinery, organic chemicals and coal increased.

What's Ahead – The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased 0.7 percent in May, with eight of the ten available indicators up. What was particularly encouraging about the May report was the fact that, after weak showings for the last few months this was a broad move to the positive side of the ledger.

COUNTIES THAT DEPEND ON FARMING

Of the nation's 2,500 nonmetropolitan counties, nearly 700 are considered farming-dependent, according to a study by the Department of Agriculture's Economic Research Service. A farming-dependent county is one in which at least 20 percent of its labor and proprietary income during the period 1975-79 was derived from farming. These counties averaged only 11,932 residents in 1980, compared with an average population of 25,613 for all nonmetropolitan counties. Forty-six percent do not have an incorporated town of at least 2,500 people and nearly 70 percent are not adjacent to a metro area. These conditions, the report concluded, make it difficult for them to become less dependent on farming. Nine of the 20 counties that depend the most on farming are located in Kansas and Nebraska. Here is a breakdown:

County	Percent of Income from Farming
Issaquena, Miss.	74.2
Slope, N.D.	71.1
Cimarron,Okla.	70.6
Arthur, Neb.	68.1
Banner, Neb.	68.0
Wichita, Kan.	64.2
Armstrong, Tex.	64.1
Wheeler, Neb.	64.1
Liberty, Mont.	63.9
Haskell, Kan.	63.7
Sheridan, Kan.	63.6
Crowley, Colo.	63.4
Greeley, Kan.	62.4
Baker, Ga.	61.6
Glassock, Tex.	61.4
McPherson, Neb.	61.1
Hodgeman, Kan.	60.5
Petroleum, Mont.	60.5
Murray, Minn.	60.4
Sully, S.D.	59.9

THE SOUTH AND WEST HAVE FASTEST GROWING METROPOLITAN AREAS

A recent report issued by the Census Bureau states that most of the fastest-growing metropolitan areas are located in the states of Texas and Florida.

The following metropolitan areas have experienced the most rapid growth in population since 1980:

	Percent Change (1980-1984)
Midland, Texas	38%
Anchorage, Alaska	30
Naples, Florida	29
Ocala Florida	27
Fort Pierce, Florida	26
Bryan-College Station, Texas	25
Odessa, Texas	25
Fort Myers-Cape Coral, Florida	23
Melbourne-Titusville-Palm Bay, Florida	21
Austin, Texas	20
West Palm Beach-Boca Raton-Delray Beach, FL	20

TAX BACKGROUNDERS AVAILABLE

The following are a series of recent studies dealing with current taxation issues prepared by the Chamber's Tax Policy Section. Individual copies of these studies may be obtained upon request by writing to Tax Policy Section, U.S. Chamber of Commerce, 1615 H Street, N.W., Washington, D.C. 20062 or by calling (202) 463-5620.

No. 1 "Reagan Soaks the Rich," September, 1984

No. 2 "Investment and Capital Cost Recovery Allowances," July 8, 1985

No. 3 "The Truth About Corporate Taxes," July 8, 1985

No. 4 "Incentive Effects of 1981 Tax Rate Reductions," (available in late July)

No. 5 "Incentive Effects of 1964 and 1922 Tax Rate Reductions," (available in late July)

No. 6 "How to do a Dynamic Revenue Estimate," (available in late July)

No. 7 "Positive Effects of Reduced Capital Gains Tax Rates," (available in late July)